cost information to be filed in order to determine the appropriate tariffed rates. Although the Commission is reluctant to require cost studies due to administrative considerations, it is essential in order to prevent the incumbent LECs from hampering competition with non-economic pricing.

Regulatory proceedings in Texas provide ample proof of the critical importance of costing information (as well as the need to adopt national policy rules). Cost studies function both to set suitable price structures and also to identify appropriate costing components. Without an effective method to screen the appropriateness of items of cost, the incumbent LEC can manipulate the pricing of an unbundled element to an exaggerated degree. This will virtually guarantee that the element is not economically and technically usable for the new entrant.

Texas state law requires that the unbundled loop be priced at a "usage sensitive" rate. Although the legislators were informed prior to the passage of the bill that the LEC cannot measure the usage of a loop that is unbundled from the LEC's switch, the provision was enacted as law because the Texas legislature was "assured" by the incumbent LEC, Southwestern Bell, that a "measuring device" existed. It was not until months following the passage of the law that Southwestern Bell identified the "device" as a modified D-4 Channel Bank. Almost immediately, the industry notified Southwestern Bell that D-4 signaling and framing were not compliant with lineside non-ISDN digital connections and were non-compliant with Bellcore technical specifications documents for lineside connections.

In addition, the initial rates for the loop would have forced new entrants to purchase loops at rates that were approximately 100% to 400% over retail prices. Further, the installation costs initially tariffed by Southwestern Bell were $166 for the first loop at a customer site and $116 for each additional end user connection.

ACTA urges the Commission to require access to be made available at cost-based rates defined as TSLRIC. The implicit subsidies built into today's access charge structure must be extracted so that a non-discriminatory, explicit universal service funding method can be established.

The existing costing structure for access is an architectural Eischer-type design that perpetually funnels considerable revenue flows to the incumbent LECs. A study conducted by Probe Research demonstrates that access fees paid by interexchange carriers since 1984 exceed the total gross plant investments for the Regional Bell Operating Companies' local networks over this same period of time.

Resale Objectives

ACTA subscribes to the scope and definition of LEC resale duties as described by AT&T in its "Initial Post-Hearing Brief" filed before the ICC on April 15, 1996, in Docket Nos. 95-0458 and 95-0531. The following discussion is based on excerpts from that filing.

ACTA members seek a "total local exchange wholesale service" offering from each LEC in all of the areas in their operating territories in which the LECs provide local exchange service. That is, the incumbent LECs must offer their retail services[2] on a wholesale basis and at an appropriate discount from the retail price. Further, the total wholesale service offering must

[2] The total wholesale service offer should include noncompetitive local service features including, but not limited to: Access Line; PBX Trunk; DID Trunk; Coin Line; Foreign Exchange Service; Local Usage Data; Flat Rated Calling; IntraMSA Toll (prior to presubscription); CLASS and Customer Calling Features; ISDN; White and Yellow Pages Directory Listings; Operator Services; Announcement Services; 911/E911, 411/Directory Assistance and Relay Service; Access to Preferred IXC; 611 and Repair Services; Lifeline Services; and Law Enforcement Coordination. Also, all new LEC services, whether introduced a trial or on a permanent basis, must be made available for resale.

include operational interfaces or support systems for data transfer requirements,[3] and administrative requirements to assure the proper and high quality provisioning of local service.[4]

To the extent that these services can be described alternatively, ACTA also supports the following service description for resale -- a "network platform approach." This approach includes all local network service features and capabilities currently offered by the LECs, including the end-to-end routing of local exchange traffic and exchange access, and the operational and support systems to provide exchange and exchange access service and certain administrative functions. Under this "network platform" approach, the wholesale offering is the lease of a complete network configuration over which the competitor may craft its own local exchange and exchange access services. Thus, there is the "retail-wholesale" approach embodied in the foregoing description of wholesale services which begins with the retail service structure of the LEC, and the "network platform" model which calls for acquisition of network components from the LEC and their recombination in ways which allow different services and service structures to be achieved and offered to end-user customers.

A variation on the platform proposal exists under which the local exchange network would effectively be unbundled into a loop, a local switch platform ("LSP") and transport. Resellers

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[3] These included access to electronic on-line systems for pre-service ordering functionalities for processing customer service orders; provisioning requirements to ensure electronic transmission of data to the ELC and order and service completion confirmation; directory listings and line information data; repair and maintenance requirements; local usage data; and Customer Account Record Entry ("CARE") Information requirements.

[4] Administrative requirements include provisioning reports comparing LEC's service to resellers and LEC's service provided to its own retail operations; direct measures of quality related to network standards; reseller branding of services; and efficient dispute resolution methods.

would be able to purchase all three of these components, bundle them together and provide local exchange and access services.

With respect to resale, Section 251(c)(4) must be read with the section on pricing of the resale (wholesale) offering, Section 252(d)(3). Taken together, these two sections impose on the incumbent LECs the duty to offer for resale, at a price equal to the retail rate adjusted to exclude the portion attributable to costs which will be avoided for each service, every retail service which it offers to end users. These services are to be available for resale without restriction, except only that resale of services offered only to a category of end users (i.e., residential) may be restricted to that same category.

The statutory language, on its face, makes clear that "any" service offered at retail must be made available by the incumbent LEC on a wholesale basis. Also, the pricing provision dictates that each service be priced at a discount from retail attributable to avoidable costs, even if the resulting price is below the wholesale LRSIC or economic cost of the service.

Pricing of Wholesale Services

Structure of Wholesale Prices vis-a-vis Retail Prices

With respect to the pricing of wholesale services, Section 252(d)(3) of the Act requires that a State Commission "determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier." All such variations from the retail rate schedule are impediments to resale competition. Therefore, the wholesale schedule of the incumbent LEC should directly mirror the retail schedule.

The Proper Wholesale Rate Structure

Anticompetitive consequences and problems can be avoided by applying one simple rule of thumb: each retail rate should have a corresponding wholesale rate. All discount structures included in the retail rate schedules must be carried over to the corresponding wholesale rate schedules.

Discount structures must be available to carriers on the same basis as they are available to end users. For example, aggregation of usage, or a service which provides both volume and term discounts to business customers on the basis of revenues generated from all the customer's accounts and locations, are arrangements available to large business customers. They must also be made available to carrier customers for resale.

Finally, imputation testing must be applied to both wholesale rates and their corresponding retail counterparts. Section 13-505.1 of the Illinois Statute sets forth imputation requirements. These requirements apply to:

> a telecommunications carrier that provides both competitive and noncompetitive services. If a carrier provides noncompetitive services or noncompetitive service elements to other telecommunications carriers for the provision by the other carriers of competitive services, switched interexchange services, or interexchange private line services or to other persons with which the telecommunications carrier also competes for the provision by those other persons of information or enhanced telecommunications services, . . . then the telecommunications carrier shall satisfy an imputation test . . . .

The statute thus requires LECs such as Ameritech to satisfy this test for switched interexchange services, regardless of competitive classification and regardless of their availability for resale. The imposition of imputation testing is an important competitive safeguard which must be preserved.

The Proper Pricing Standard and Cost Basis for the Wholesale Offering

Section 252(d)(3) of the Telecommunications Act sets forth the methodology for establishing wholesale prices for telecommunications services. It states that "a State commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection and other costs that will be avoided by the local exchange carrier." Thus, the Act provides specific guidance on how the prices for wholesale services are to be set and prescribes a methodology for evaluation of the LECs' cost basis for wholesale prices.

The statutory language has direct and immediate implications for the proper costing and pricing methodology. First, the phrase "will be avoided" refers to costs that are avoidable in the long run. Near term or short-run costs do not meet this test. Experts have testified, "[A] wholesale pricing methodology that considers only the retail costs avoided by the incumbent LEC through the substitution of one unit of wholesale service for one unit of retail service is clearly inconsistent with the Act."

Moreover, this pricing standard requires that retail prices be adjusted to eliminate the portion that would no longer exist if the LEC withdrew entirely from the retail service business. And certainly the term "costs that will be avoided" does not allow the LEC to choose not to reduce its retail expenses thereby generating no "avoided" costs. Such a result would be plainly inconsistent with the Act and its procompetitive purpose.

Moreover, the statutory language does not make any provision for offsetting avoided costs by any costs supposedly incurred by the incumbent LEC in providing the wholesale service.

Allowing such costs to be "netted" against costs "that will be avoided," moreover, would be tantamount to reverting to rate of return regulation and its system of guaranteed cost recovery.

Methodology for Establishing Wholesale Rates

AT&T expert witnesses have presented a method of measuring avoidable costs based on publicly available LEC accounting data for retailing functions. This approach yielded a discount of 25% from retail prices. In addition, it was also proposed that an additional incentive discount of up to 10% be available for operational interfaces that are not yet at parity with the LEC's own retailing operations. This additional discount of up to 10% provides the LECs an incentive to bring these interfaces into conformity with the interfaces which serve the LECs' own retailing operations. The discount also compensates resellers for the fact that the wholesale services they are receiving are not equal in quality to the LECs' own retail services.

Such a "top down" accounting-based method is fully consistent with the language in the Act. It is, however, necessarily "broad-brush" in nature because it develops only one percentage equally applicable to all services. A more service-specific development of wholesale prices can be achieved based upon evidence gathered and with several adjustments required to add precision and assure consistency with the Act.

LEC Cost Data

A cost study which had the objective of measuring cost changes that would occur if 100% of services available for resale were converted from a retail environment to a wholesale environment, is a conceptually correct starting place. Two modifications are essential, however, before the results can be used to set wholesale prices. Specifically, the retail-to-wholesale difference needs to be increased to account for: (1) inefficiencies in the LECs' retail and wholesale operations; and (2) costs that will be avoided, but which may not be identified in the cost study.

A method which uniquely treats individual service elements is superior to a method which applies discounts broadly to entire service families. An individual service element approach avoids the introduction of unnecessary and undesirable variation in the contribution margin between the corresponding wholesale and retail versions of the same service. Such an approach is also consistent with the Act, which describes the wholesale rate calculation methodology for "the telecommunications service requested . . . ."

Inefficiency Adjustment

The calculation method relying on individual service element approaches essentially reduces retail prices by avoided costs including a pro rata share of contribution. The inclusion of a pro rata share of contribution is essential to bridge the gap between say a theoretical LRSIC methodology and the practical reality of the manner in which the LECs actually provide service. The calculation of wholesale prices should account for inefficiencies which presently exist in the LECs' operations. While a pro rata contribution adjustment captures the inefficiency inherent in the LECs' existing retail operations, it is conservative in that it does not account for the inefficiencies which must be adjusted out of the LECs' wholesale/network operations before a proper wholesale discount can be established. Additional adjustment is required for this purpose.

Additional Costs that Will Be Avoided

Support Expenses. The calculations in the approach of assuming that 100% of services available for resale convert from retail to wholesale is overly conservative in identifying the costs that would be avoided under such a scenario. For example, such a large scale shedding of retail activity would inevitably lead to reductions in buildings, vehicles, computer equipment, furniture and artwork, personnel employees. The full effect of these predictable reductions needs to be incorporated into the analysis.

Advertising. Advertising expenses that would be incurred in a wholesale environment have been characterized as "associated only with trade shows, trade publications, and various product guides and other materials." There is simply no justification for incurring this cost which does not benefit resellers. It does not make sense for a LEC to advertise and promote essential monopoly wholesale services to informed resellers who must have such inputs in order to provide their own services.

Uncollectibles. The uncollectible factor should be adjusted to remove the effects of end user customers; however, after this adjustment, it is possible that the LEC's factor will still be based on experience with information providers, interexchange carriers, independent LECs, competitive access providers and Centrex resellers. This disparate mix of company types overstates the uncollectible expenses the LEC will experience in a wholesale environment. New entrants into the local exchange market will have the kind of technical, managerial and financial capabilities that will result in an uncollectible expense more in line with that experienced with interexchange carriers (as opposed to operators of psychic hotlines). For example, using Ameritech's own workpaper in the ICC proceeding, AT&T demonstrated that uncollectibles for interexchange carriers were virtually non-existent.

Incremental Wholesale Costs. Finally, rates would be set after considering ongoing wholesale cost increases (incremental wholesale costs) as well as avoidable costs. However, it is noted that "the Act could be interpreted to suggest that such a cost differential should not account for any wholesale costs which are incremental to the provisioning of wholesale services. If the Commission adopts this interpretation, Ameritech's cost methodology should be modified so that it does not account for incremental costs." As discussed above, Section 252(d)(3) of the Act does not make any provision for offsetting avoided costs with additional costs the LEC claims are incurred in offering wholesale service. The Act refers only to "costs that will be avoided by the local exchange carrier."

Summary of Required Modifications to the Wholesale Discount

As adjusted, the cost study in the ICC proceeding yielded an overall average discount in the range of 20%. As the foregoing discussion shows, this discount needed to be increased to account for:

- Inefficiencies which must be adjusted out of the LECs' wholesale network operations.
- Reductions in expenses associated with buildings, vehicles, computer equipment, furniture and artwork, personnel employees and other assets and functions presently supporting retail operations.
- Elimination of advertising which will not benefit resellers.
- Reduction of uncollectible expense to reflect a more representative group of companies.
- Elimination of incremental wholesale cost offsets.

If all are quantified and input into the pricing formula which adjusts retail prices for avoided costs, the discount would be substantially increased. In order to avoid studying the issue excessively which would introduce the possibility of delay, ACTA recommends, at a minimum, that a baseline wholesale discount of 25% be used.

While not achieving the full level of discount, ACTA believes a properly developed record would support an average 25% discount. A mathematical result like this could be achieved by ordering the LECs to use a formula to adjust all wholesale rates, such as the following suggested by AT&T to the ICC:

$$\mathbf{R_{W(NEW)} = R_R - [(R_R - R_W)(25.00/XX.XX)]}$$

Where $R_{W(NEW)}$ = New Wholesale Rate
R_R = Retail Rate
R_W = Original wholesale rate on Exhibit 1.05P

XX.XX = Staff's percentage discount

This formula adjusts the retail to wholesale margin for each service so that the overall result for all services approximates a 25% margin. This adjustment does not alter the desirable characteristic of a method that retail to wholesale margins bear a relationship to individual service profitability.

Wholesale Tariff Pricing

LECs should be required to file wholesale tariffs, based on the foregoing methodology and the additional adjustment described by the formula above. Each tariff should be accompanied by supporting calculation workpapers and a narrative description of the avoided cost methodology utilized. These materials should be available to all parties. Smaller LECs could similarly be directed to file a wholesale tariff, calculations, and narrative methodology within 30 days of an order to do so, being given the option of either: (1) using the percentage discounts derived by the larger incumbent LECs for individual services (including the additional adjustment set forth in the formula above); or (2) a straight 25% discount across the board to all services, to be trued up when and if it completes its associated cost studies. A reasonable additional period of time (e.g., 30 to 45 days) should be available during which the tariff rates could be trued up if necessary based on review of the tariff and its supporting calculations by interested parties.

Conclusion

The Commission has a huge task ahead of it, with little time to act. ACTA strongly urges that in adopting its policies in this critical area, it "err" on the side of boldness. That is, based on the known efforts of the incumbent LECs to delay and frustrate achievement of competitive local exchange services, based on their own admissions against interest in describing the inherent tendency of any monopoly to make opening its domain as difficult as possible, the Commission must move decisively, by deciding its actions on the basis of realities. This will require the Commission to abandon any effort to dignify, by giving any consideration to, what are patently bogus excuses for delay, refusals to deal and thinly veiled obstructionist tactics.

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The Commission is aware of what needs to be done. Given the short time frame in which to do it, no time should be lost in tolerating the type of tactics being used to delay the inevitable, or in attempting to deal with bogus claims of harm or infeasibility or with sham excuses that different methods of dealing with other carriers is necessary because of the change in environment in which those dealings are to take place from monopolistic to competitive. The Commission's performance in carrying out the will of Congress and acquitting its own dedication to greater competition will be measured by its success in carrying out its duties to implement the policies and rules necessary to effect true competitive interconnection and resale of local services.

Respectfully Submitted,

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